

*Citation for published version:*

Zalewska, A 2014, 'Challenges of corporate governance: Twenty years after Cadbury, ten years after Sarbanes-Oxley', *Journal of Empirical Finance*, vol. 27, pp. 1-9. <https://doi.org/10.1016/j.jempfin.2013.12.004>

*DOI:*

[10.1016/j.jempfin.2013.12.004](https://doi.org/10.1016/j.jempfin.2013.12.004)

*Publication date:*

2014

*Document Version*

Peer reviewed version

[Link to publication](#)

*Publisher Rights*

CC BY-NC-ND

Published version available via: <http://dx.doi.org/10.1016/j.jempfin.2013.12.004>

## University of Bath

### Alternative formats

If you require this document in an alternative format, please contact:  
[openaccess@bath.ac.uk](mailto:openaccess@bath.ac.uk)

**General rights**

Copyright and moral rights for the publications made accessible in the public portal are retained by the authors and/or other copyright owners and it is a condition of accessing publications that users recognise and abide by the legal requirements associated with these rights.

**Take down policy**

If you believe that this document breaches copyright please contact us providing details, and we will remove access to the work immediately and investigate your claim.

**Challenges of corporate governance:**  
**Twenty years after Cadbury, ten years after Sarbanes-Oxley**

(forthcoming in the Journal of Empirical Finance)

**Anna Zalewska<sup>1</sup>**

CGR, School of Management, University of Bath, UK

CMPO, University of Bristol, UK

29 November 2013

**Abstract**

This paper sets the background to the Special Issue of the Journal of Empirical Finance on Challenges of Corporate Governance. It identifies the alternative approaches that can be taken to solve agency problems stemming from asymmetries of information: (i) ex-post monitoring through audit and information provision, (ii) ex-ante monitoring through boards, and (iii) incentivisation through the alignment of managerial incentives with shareholders. It discusses how the UK and the US have responded to corporate failures and relates the development of regulation in these countries to the three alternative approaches. It concludes with a discussion of three groups of challenges: (i) understanding alternative regulatory approaches, (ii) determining the importance of geo-diversity of business culture, and (iii) overcoming the problems of the political economy of corporate governance.

**Acknowledgements:** I would like to thank all participants of the conference “Challenges of corporate governance: Twenty years after Cadbury, ten years after Sarbanes-Oxley”, 24-25 June 2013, for making the conference such a great and successful event. In particular, I would like to thank Professor Kevin Murphy and Professor David Yermack for their inspiring talks as the Keynote speakers and during the conference interactions. I would also like to thank Lord Ian MacLaurin, Lord Christopher Tugendhat, Sir Julian Horn-Smith, Philip Lowe and Charles Tilley for a fantastic panel discussion. Last, but not least, I would like to thank the School of Management for hosting the event, the Journal of Empirical Finance for hosting this special issue and the Research Committee and anonymous Referees for their support in selecting papers for the Conference and this Special Issues.

**JEL classification:** G35, J33, L29

**Key words:** Corporate governance, agency problems, boards of directors, incentive pay

---

<sup>1</sup> **Corresponding address:** School of Management, University of Bath, Bath, BA2 7AY, UK; Tel: +44 01225 384354, Bath, BA2 7AY, UK; Email: a.zalewska@bath.ac.uk

## **1. Introduction**

The last two decades have witnessed enormous changes in corporate governance practices and structures. While what are commonly referred to as the Anglo-Saxon, Franco-German, Scandinavian, and other corporate governance models took centuries to evolve, governments, regulators and shareholders have, since the 1990s, transformed the ‘natural’ evolution of corporate governance into a revolution. This article sets the background to the development of corporate governance reforms over the last twenty years and provides a discussion of three groups of challenges.

An obvious question is why has corporate governance changed so dramatically in this period? An easy answer would be corporate scandals. There have been many corporate scandals since the late 1980s. Moreover, these have not been ‘ordinary’ scandals. They exposed a high level of mismanagement (involving illegality as well as lack of competence) and resulted in unprecedented loss of money. In some cases the damage was not only restricted to individual corporations, but whole sectors have been pulled down, and even economies. This obviously focused attention on the questions: how in the modern world has it been possible for a few to take advantage of so many, who failed in this process, who should be held responsible, and what should be done to ensure that frauds like those of Adelphia Communications, Coloroll, Enron, Maxwell Group, Nortel, Parmalat, Polly Peck, Royal Ahold, Satyam, WorldCom, to name just a few, do not happen again? Against this backdrop, it was almost inevitable that there would be enormous interest in changing the regulatory structure. Of course, large scandals leading to large regulatory change is a high-level explanation, and it is necessary to dig deeper to understand the form of regulatory change that occurred.

Asymmetric information is at the heart of agency problems and is commonly thought to lie behind the market failures and the associated corporate scandals. But is asymmetric information more of an issue in the modern business environment than before? There are reasons to think that this may be so.

First, the emergence of large scale businesses with complex organisational forms may have significantly increased opaqueness within corporations, resulting in greater informational asymmetry between investors and management. Second, paradoxically, the asymmetry may have also increased as a result of informational technological progress. This

is because, while on one hand, more information is now available, it may also cause information overload, hence, it may be more, rather than less difficult to extract information that is relevant and important.

Third, it also seems that longer-run changes in ownership structure may have contributed to this change. The unprecedented growth of stock markets with the associated spread of ownership is thought to have decreased the ability of shareholders to monitor management. It also seems that the transformation of ownership from individual shareholders to institutional investors has not mitigated this problem. Numerous studies show that individual (small-scale) investors are not particularly rational in their investment decision making process (e.g., Benartzi and Thaler, 1995; Odean, 1998; Barber and Odean, 2011). Given that they are also dispersed and face difficulties with communication and coordination, it may be overoptimistic to expect that, even if provided with relevant and correct information, they would have sufficient incentive to undertake the appropriate steps to resolve issues arising. The existence of institutional investors does not seem to resolve the problem, either. Although, institutional investors are believed to be more knowledgeable than ordinary investors (e.g., Schmeling, 2007) they hold diversified portfolios and do not have the capacity to closely oversee each individual company they invest in, especially if they invest in numerous foreign markets. Institutional investors may also not have the incentive to engage in costly monitoring. Even though they are long-term investors, by the nature of their business (e.g., pension funds), their managers are rewarded for short-term performance, hence they may prefer to exercise ‘exit’ rather than ‘voice’, if a market is sufficiently liquid. Therefore, there seem to be no natural principals who may be willing and able to sufficiently monitor the inner decision making and operational processes of companies.

Against this background of weak natural market mechanisms it is possible to see why there has been a drive to increase regulation. It is responsibility of boards and auditors to provide the market with correct and relevant information and hence it is not surprising that regulation has focused on these aspects. The following section (Section 2) identifies alternative approaches that can be taken to solve the problem, e.g., (i) ex-post monitoring through audit and information provision, (ii) ex-ante monitoring through boards, and (iii) incentivisation through the alignment of managerial incentives with shareholders.<sup>2</sup> Section 3 discusses how the UK and the US have responded to corporate failures and relates the

---

<sup>2</sup> Throughout the paper the term ‘board’ will be predominantly used to describe nonexecutive directors.

development of regulation in these countries to the three alternative regulatory approaches identified above. The paper focuses on the UK and the US experience in part because more than anywhere else they have engaged in making significant changes to their corporate governance. Moreover, although they are the core countries of the Anglo-Saxon governance system, the changes have been very different in the two countries. In addition, these changes have inspired regulators in other countries to follow their lead. Finally, Section 4 closes with a discussion of challenges.

## **2. Conceptual background**

### **2.1 What is corporate governance?**

Corporate governance can be defined as “the system by which companies are directed and controlled” (Cadbury Report, 1992). While this is an adequate definition as to what research themes can be considered as corporate governance topics, it does not help in providing insight into what might constitute good or bad corporate governance. To move in this direction, i.e., from a normative to positive approach, we need to look towards narrower definitions that provide some indication of objectives and acceptable ways of achieving them. However, once we move away from simple definitions such as that in the Cadbury Report (1992), there is much written but little consensus on the subject.

This lack of unanimity is, at least in part, a consequence of the diversity of corporate governance forms. The diversity stems from historically different political and legal systems, forms of industrial organisation, and differences in cultural, moral and religious beliefs and models. Therefore, it is practically impossible for one definition to capture cross-country specific characteristics regarding the ways companies are organised, run, monitored and made accountable for their decisions, behaviour and development to define what is good and what is not. For instance, in countries where firms are perceived as organisational forms ‘owned by millions and controlled by one’ a focus on understanding corporate governance as “the ways in which suppliers of finance assure themselves of getting a return on their investment” (Shleifer and Vishny, 1997) fits in with a rather narrow understanding of the firm’s purpose and obligations by focusing on a relationship between the shareholders and the management.

Such an understanding of corporate governance would not be adequate, however, in systems where the finance providers' interest is 'one of' but not 'the sole' objective of a firm. For example, in systems in which stakeholders' interests are to be taken into consideration, good corporate governance can be measured by whether decisions are made "to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy (interest of the enterprise)" (German Corporate Governance Code, 2010).

## 2.2 Monitoring and Incentives

Whatever the objective of a company, the separation of ownership and control is seen as a source of problems, notably the asymmetry of information that arises between the parties and the (related, albeit formally distinct) incentive for owners to free-ride on benefits brought about by intervention and pressure from other shareholders. Economic theory suggests that monitoring and/or alignment of agent's incentives with the principal's objectives are useful tools in reducing the consequences of the asymmetry of information in the principal-agent relationship. However, the extent that individuals have an incentive to engage in monitoring and press for greater alignment of incentives depends on the dispersion of ownership, with greater dispersion diluting a shareholder's benefit from his/her effort and intervention.

It is worth mentioning two points. First, in most models of asymmetric information (e.g., standard moral hazard, adverse selection or signalling models) the asymmetry brings about a deadweight loss relative to the full information alternative. Hence, it is unrealistic to expect any model of corporate governance to prevent the problems caused by the asymmetry of information and the dispersion of ownership. Failure to recognise that regulation of corporate governance can only mitigate rather than remove the deadweight loss is likely to lead to ever increasing regulation. Second, there may be many ways of dealing with the underlying problem with different balances between greater incentives and greater monitoring. No one way may be superior in the absolute sense and the solution may be heavily dependent on the situation, which leaves space for a wide range of modifications and tailoring. Within the medley of possibilities there are, however, some general patterns which can be identified and help to provide a better understanding of possible approaches and their outcomes.

### 2.2.1 Monitoring

Monitoring describes mechanisms and actions undertaken by or on behalf of the principal which keep an update on the agent's progress in delivering outcomes he/she has been contracted to deliver. Monitoring is costly although the cost of monitoring can be reduced by other costly activities. For example, there is a negative relationship between the cost of monitoring and salary. If one is willing to pay above the 'market rate', then losing the current job is costly for the agent, hence, the agent is less likely to risk losing the position by 'shirking'. This means that the principal may not need to engage in so much monitoring to bring about the desired outcome (Shapiro and Stiglitz, 1984). The harder it is to monitor, the more alternative practices such as this may be useful.

Turning to the question of which type of monitoring is most effective, in practice, there are two possibilities: ex-ante and ex-post monitoring. Ex-ante monitoring refers to controlling and influencing what project and implementation route are chosen. If there are several projects to choose from, and these projects differ in their characteristics (they have different risk-return characteristics, different value at risk, etc.) an agent might choose different projects than the principal would. Therefore, ex-ante monitoring which project is to be chosen and implemented at the time when a decision is made, may help to secure that a chosen project is more congruent with the principal's objectives and preferences. In practice, a strong board is a necessary condition for ex ante monitoring. Weak boards, i.e., boards without the required expertise and/or dominated by CEOs or other powerful executives will not effectively contribute to a decision making process and provide effective representation of shareholders/stakeholders' interest. Their advisory and monitoring role will be reduced to 'rubber stamping' of choices made at the executive level. Strong boards, in contrast, can provide the required level of expertise and, if necessary, form constructive opposition to the executive decision making process.

Ex post monitoring refers to assessing the quality of the results once the project is completed or under way. That is, at the end of the project's life, the agent's efforts and the effects of their realisations are subject to scrutiny. This is done by auditing, both internal and external. Whether ex post monitoring is successful depends on the quality of audit. It is common these days that an audit committee, at company level, is created to enhance internal auditing. Its membership is often tightly regulated by laws or codes to ensure high quality internal control mechanisms independent from potential influences of executives. The role and responsibility of external audit has also been increasing over the last few decades. In the debate on the extent of audit required it is important to keep in mind, however, that forcing

auditors to convey full information can be less informative than when they are allowed to use their discretion to withhold information (Grout et al., 1994).

### 2.2.2. Incentives

Given the core of the agent-principal conflict arises from the different objectives of the agent and the principal, an alternative to monitoring to mitigate the problems is to reward the agent in a manner that aligns the agent's incentives with the principal's. This may be a better route than restricting him/her from making decisions that would potentially lead to outcomes incongruent with the principal's best interest. In other words, setting up incentives that will make the agent 'voluntarily' act as if he/she were the principal (rather than just watching over the agent's shoulder to make sure that he/she makes decisions congruent with the principal's best interest) might be the solution to the agent-principal conflict.

The literature on managerial incentives is enormous. It is mainly focused on monetary incentives (i.e., related to remuneration), although a fair amount of attention is paid to issues related to job satisfaction (e.g. Kale et al., in this issue). The traditional approach to setting up remuneration incentives for agents is based on the notion of making agents into 'semi-principals', i.e., making them part owners of companies they are employed by, which will reduce the gap between agents' and principals' objectives. Unfortunately, making agents shareholders in the companies they are employed by, does not turn agents into '100%' principals (e.g., their risk attitudes, scope for diversification and preferences may remain sufficiently disjoint to hamper full alignment of interests), hence, in practice, it is impossible to eliminate all the agency problem this way. Moreover, as Bebchuk and Fried (2003, 2004) argue, remuneration contracts themselves may be the result of the agency problems, as stock options may represent "undue" reward for powerful executives.

In practice, there are three forms of incentives commonly used in executive remuneration: bonuses, options and shares. While bonuses are frequently linked to accounting performance, value of options and shares is determined by the market share price and the option strike price. They are, however, not equivalent incentive instruments. Option grants and share grants may have different implications for risk taking. Other things being equal, if executives have their remuneration tied up in options, they may have additional preference for risky projects, as options provide an asymmetric payoff at maturity. There is also a controversy, widely debated in the finance literature, that awarding options and shares dilutes the effect of granting options if executives are allowed to trade in shares



(diversification effect). This view is supported by empirical evidence showing that granting of options is associated with some sales of discretionary stock holdings (e.g., Ofek and Yermack, 2000). However, numerous other studies do not find such practices. Indeed, there is strong evidence that, despite the ubiquity of generous stock option packages, executives hold large volumes of their company stock by choice (e.g., Bolliger and Kast, 2004; Khan, et al., 2005). Grout and Zalewska (2012) show that the substitution effect (i.e., when options are granted executives reduce their holdings of shares), and the complementarity effect (i.e., granting options stimulates share purchases), can be explained if managers have superior knowledge of the quality of their match with the firm that has hired them. They show that allowing managers to trade in shares when options have been granted can have a positive impact on managerial effort.

In spite of numerous controversies related to the effectiveness of equity-linked incentives, granting of shares and options has become a popular and significant component of executive remuneration. The US became a pioneer in this regard. According to statistics provided by Forbes, in 2012 an average CEO gained over \$3.2mln (or over 30% of the total compensation) from equity-linked compensation. This may be a drop from over \$8mln (or over 65% of the total compensation) in 2002, but is still a significant fraction of what CEOs earn.<sup>3</sup> The UK statistics are much more modest (Conyon and Murphy, 2000; Conyon et al., 2011).

### **3. Corporate governance reforms**

What practices are perceived as good corporate governance and how boards are structured depends, in part, on the type of principal. For example, in systems where the principal is defined broadly, (supervisory) boards will commonly include employee representations (e.g., Sweden, Germany). In systems where shareholders are the principal, employee representation on boards will not be the norm (e.g., the UK, the US). Non-executive directors are there to represent and report to shareholders. However, although the core characteristics of the shareholder and the stakeholder corporate governance models have taken centuries to form, it does not mean that these forms are fully defined and complete in

---

<sup>3</sup> <http://www.forbes.com/lists/2012/12/ceo-compensation-12-historical-pay-chart.html>

their evolution. As the economic and the business environments change, so do the corporate governance systems.

Indeed, how companies are governed, and what is acceptable as a form of good corporate governance has changed significantly in the last few decades. The major changes have occurred, or at least have been initiated, within the Anglo-Saxon corporate governance system. Moreover, one could also argue that the UK has been the country which led and successfully propagated important reforms. In particular, the Cadbury Report (1992) and its Code of Good Practice initiated a series of fundamental changes in the UK and abroad. The Cadbury Report (1992) was not the only code of good practice issued in the early 1990s, but it is the document with unprecedented national and international impact.<sup>4</sup>

Historically, the relatively stronger position of a CEO in the Anglo-Saxon governance system is one of primary differences between it and the other systems of corporate governance. The Cadbury Report (1992) laid the fundamentals for empowering boards and limiting CEOs' influence over the board and decision making. This was a bold and innovative way of strengthening internal monitoring. To some extent it was breaking out of the Anglo-Saxon tradition by turning UK governance away from the path taken by the reformers of the US governance system.

The difference between the UK and the US in their approach to corporate governance reforms is clearly visible in how the changes have been introduced. While UK corporate governance restructuring has been done on a voluntarily basis of the 'comply and explain' principle, in the US any fundamental changes in corporate governance practices and structures are enforced by law and subject to penalties for non-compliance. Consequently, while it is common for non-listed British companies to voluntarily comply with codes of good practice, although these are designed for the listed ones, in the US non-listed companies having no obligations to obey the SEC rules, are not expected to implement them. The differences between the UK and the US approaches to corporate governance restructuring are also evident in the issues of concern.

### 3.1. The UK experience

The UK approach is focused on improving the architecture of boards and developing their stewardship. The recommendations and guidance expressed in the Cadbury Report

---

<sup>4</sup> In 1990 in Australia, the Bosch Committee was established and published "Corporate practices and Conduct". In 1992 in South Africa, the King Committee was established and published its report in 1994.

(1992) focused on improving internal monitoring. This was in response to the unexpected and sudden financial collapses of Coloroll and the Polly Peck consortium in the late 1980s, which were soon followed by two further scandals: the collapse of the Bank of Credit and Commerce International in June 1991, and the bankruptcy of the Maxwell Group in 1992.

There was no doubt that the collapse of the four companies resulted from ill management practices and creative accounting. Dominant and even ‘bullying’ CEOs, with high concentration of power, surrounded by rubber-stumping boards created a fertile environment for aggressive empire building and risky financial practices. Although, in each of these cases audit, both internal and external, had failed, the proposed recommendations were focused on empowerment of boards. For example, it was done through balancing the power between executive and nonexecutive directors, and, in particular, between CEO and Chairman, introduction of various internal committees, and proposed the clear distinction between independent and non-independent nonexecutive directors. Since then there have been several more reports and recommendations. These have taken the Cadbury Report (1992) as their base and have further enhanced stronger and more effective boards. For instance, the Hampel Report (1998) states that “separation of the roles of chairman and chief executive officer is to be preferred, other things being equal, and companies should justify a decision to combine the roles”. The Higgs Report (2003) proposed further empowerment of non-executive directors (e.g., by proposing that they form the majority of the board), and further constraining the power of the CEO (e.g., a retiring CEO should not progress to Chair, and the Chair should be independent). The Tyson Report, also published in 2003, focused on board issues, its independence and diversity. The role of institutional investors has also been addressed (e.g., ISC Reports, 1991, 2005; Myners Report, 2001).

In other words, the corporate scandals of the early 1990s triggered a series of reports commissioned by numerous bodies (e.g., the London Stock Exchange, the Financial Reporting Council, the UK Government, the accountancy profession) that recommended changes to corporate governance practices. None of the recommendations were law, and there were no penalties for not following the recommendations. The last twenty years can be described as a steered and evolutionary transformation of British corporate culture.

### 3.2. The US experience

The US response to corporate scandals has been different. In their anatomy US corporate scandals of the early 2000s are quite similar to the UK’s corporate scandals of the

early 1990s: dominance of the top management, weak boards, creative accounting undetected by external audit. Yet, the response of American authorities was to increase audit requirements, and demand more disclosure on executive remuneration rather than empower boards and reduce the power of CEOs.

Indeed, the Sarbanes-Oxley Act (SOX) of 2002 introduced strict and very costly auditing practices for companies listed on the NYSE and NASDAQ. It also defined criminal penalties for not complying with the regulation and/or violating prudent accounting practices. This ex-post monitoring of executive decision making and performance has been accompanied by an increase in vigilance over executive remuneration and enforcing performance-linked remuneration incentives.

Indeed, public disclosure of executive remuneration has a long history in the US. In 1992, in the same year as the Cadbury Report (1992) was published, the SEC introduced the Executive Compensation Disclosure Exchange Act (57 Federal Regulation 48126, 48138) which requested disclosure of executive remuneration<sup>5</sup>. This was a significant extension of the requirement (the Securities Act of 1933 and the Securities Exchange Act of 1934) to describe executive compensation programmes for the most recently completed fiscal year in company's registration and annual proxy statements. In 1993, the Congress amended the Internal Revenue Code, which, practically speaking, enforced the use of 'performance-based' compensation. This is because, according to the Code, performance-based compensation was still tax exempt, while 'fixed' remuneration in excess of one million dollars could not be treated as a company expense. Therefore, companies paying high fixed compensation would lose their federal tax deduction, making fixed remuneration unattractive from a company's tax perspective.<sup>6</sup>

SOX further interfered with remuneration practices at the company level by prohibiting personal loans to directors and executive officers (which were commonly granted, for example, to facilitate conversion of options), and placing restrictions on company stock sales during retirement plan blackout periods. It also introduced restrictions on potential payments to executives if the company faced accounting restatements or during periods of

---

<sup>5</sup> Mobley (2005) provides a comprehensive discussion of federal regulation related to executive compensation.

<sup>6</sup> In contrast, the Greenbury Report (1995), although recommending full disclosure and performance-based compensation policies, also set effective restrictions on using options by removing companies' ability to issue personal loans to executives to finance the conversion of options into shares. The Hampel Report (1998) issued a "caution in the use of inter-company comparisons and remuneration surveys in setting levels of directors' remuneration", and "urge(d) remuneration committees to use their judgement in devising schemes appropriate for the specific circumstances of the company."

investigation if a company is charged with a violation of the securities laws, until conclusion of the proceedings was reached.

The prohibition of personal loans is of particular importance as it has direct consequences for the incentives induced by the Internal Revenue Code of 1993. The consequence of the SOX regulation is that directors may have to use their own savings or externally borrowed money when converting options into shares that have been granted to them as part of performance-based remuneration. One can easily expect that, with the drying up of internally granted loans, the remuneration of executives will go up to compensate for the additional cost of borrowing.

In 2006 the SEC adopted the Compensation Disclosure and Analysis Act which was intended to introduce “plain English” to the convoluted and lengthy explanations of post-SOX reports. It also specified that companies should provide remuneration information for CEOs, CFOs, and the three other highest paid executives and non-executive directors to give full and comprehensive information about remuneration practices.

A new wave of regulatory changes entered the market with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010. “The 2,319 pages contained the blueprint for 243 rule-makings along with numerous studies and reports ensuring that it will take years before the reforms aimed at preventing the recurrence of a similar financial crisis in the future are actually in place and operational” (Demsey, 2013). Indeed, the implementation of over 100 required and discretionary provisions faces considerable difficulties. Demsey (2013) notes “(i)n early 2013, nearly three years from its enactment, a quarter of mandatory rule-making provisions were yet to be proposed, with many of the other three-quarters still in the provisional stage and some of the most significant facing challenge”.

The Dodd-Frank Act of 2010, among many other issues addressed once more executive remuneration disclosure. It required that, in addition to information about the remuneration of executive directors and the assessment of performance justifying the financial rewards, companies will also disclose the median annual total compensation of all employees and the ratio of this median to the total compensation of the CEO. It also required companies to disclose whether any directors or employees were permitted to purchase financial instruments designed to hedge or offset a potential decline in the value of company’s securities that were held by them as part of their compensation. The Dodd-Frank Act (2010) also empowered shareholders to have a “say on pay” of executive directors named in annual proxy statements. This is, however, a non-binding vote, that can be cast at least

once every three years.<sup>7</sup> Special attention has also been paid to the independence of remuneration committees and role of compensation consultants. Again, this empowerment of shareholders seems superficial and may result in sporadic knee-jerk actions by dissatisfied shareholders. It does not build a platform for continuous dialogue and the creation of prevention mechanisms. It seems to continue the spirit of assessing ex-post performance and applying punishment if proven unsatisfactory.

An interesting aspect of the Dodd-Frank Act (2010) is in its ‘undoing’, or softening, of some elements of the SOX auditing requirements. The Dodd-Frank Act (2010) had an exemption for companies with market capitalisation below \$75 million from the requirement of an internal control assessment by management. It also requested the SEC to investigate and propose how to soften the burden of complying with Section 404(b) of SOX for companies with market capitalisation between \$75-250 million without decreasing protection for shareholders.

Finally, the Dodd-Frank Act (2010) requested the SEC to issue rules mandating listed firms to disclose the reasoning behind their board leadership structure, and, in particular, why they do not have separate Chair and CEO positions, if they have one person holding both posts. This requirement crowned several proposals of the Congress introduced in 2009 that called for the separation of CEO-Chair duality, and the requirement that firms that received assistance under the 2008 Troubled Asset Relief Program (TARP) were obliged to separate the CEO and Chair positions.

This new approach to the division of power within a board has been received with a considerable level of hostility within business circles, although corporate governance activists are supportive of it. To illustrate, in 2012 the American Federation of State, County and Municipal Employees (AFSCME) filed proxy proposals aimed at separating the roles of chairman and chief executive at Goldman Sachs Group Inc., J.P. Morgan Chase & Co, American Express Co., Janus Capital Group Inc., Northern Trust Corp., and four other big companies.<sup>8</sup> Their attempts were only partially successful.<sup>9</sup> This is a very different experience from how the proposal to separate CEO and Chair positions was received in the UK.

---

<sup>7</sup> Companies are required to hold a non-binding shareholder vote no less than once every six years on whether the non-binding shareholder vote on ‘say on pay’ should be every year, two years or three years.

<sup>8</sup> “Union target dual Chair-CEO roles”, Reuters, 17 January 2012 <http://www.reuters.com/article/2012/01/17/us-executives-independence-idUSTRE80G0MI20120117>

<sup>9</sup> “Union disapproves of Goldman’s choice for lead director”, The Wall Street Journal, 4 April 2012 <http://www.efinancialnews.com/story/2012-04-04/afscme-unhappy-goldman-sachs-lead-director>

In the UK companies accepted the separation as advised by the Cadbury Report (1992), and in no time, the separation was so deeply enrooted in corporate practices and culture that any attempt to combine the positions was taken with great hostility. The case of Sir Stuart Rose of Marks & Spencer, who failed to find investor support to become executive Chair, in spite of having many successful years as a CEO, is one of many examples of opposition to the CEO-Chair duality in Britain.<sup>10</sup>

### 3.3. Summary

In summary, there are stark differences in the steps taken in the UK and the US to improve corporate governance. The British focus on ex-ante monitoring is enacted through empowerment of boards and, in particular, empowerment of non-executive directors. This is achieved through an imposition of ‘strict’ independence of non-executive directors, creation of various committees consisting entirely of non-executive directors or their majority, having a senior non-executive member of a board to whom all enquiries can be directed, and also that non-executive directors are at least as numerous as executive ones. The separation of CEO and Chair positions, and, indeed, the introduction of the non-executive Chair, aims to reduce the power of the CEO and of executive directors. By design, British boards are to be active and powerful monitors. The monitoring is also conducted at higher than annual frequency, as boards, unlike annual reports, meet several times a year. In these conditions auditing is another supporting mechanism, rather than the main mechanism of monitoring.

This is in stark contrast to the American approach. The concentration of power in the hands of a CEO, frequent dependence of non-executive directors, weaker shareholder rights, etc., may make American boards weaker controlling and advising bodies. In this situation, audit plays a crucial role in informing shareholders about the state of affairs.

Incentives are another way of resolving agency problems. These however, seem even more complicated in their design and implementation than monitoring. Weaker ex-ante monitoring of American boards, is to some extent addressed by greater use of performance-based remuneration. In the US equity linked compensation is used more frequently than it is used in the UK. It is also true that a higher fraction of executive remuneration is paid in options and shares in the US than it is in the UK.

---

<sup>10</sup> “M&S failing to mollify shareholders over Rose’ rise to chairman”, The Guardian, 1 April 2008 <http://www.theguardian.com/business/2008/apr/01/marksspencer.retail>;  
“Stuart Rose must quit as M&S chair next year, says investor group”, The Guardian, 30 March, 2009 <http://www.theguardian.com/business/2009/mar/30/m-s-stuart-rose-executive-chairman>

#### **4. What are the challenges?**

The last few decades have delivered considerable evidence of poor corporate governance practices. Many of the problems may be traced back to the effects of asymmetric information between executives and shareholders. Yet, the solutions adopted by individual countries to deal with the potential causes of corporate governance failures have been substantially different. In the previous section I concentrated on how the UK and the US have responded to corporate failures. I argued that the differences between the two countries were in terms of (i) the solutions that were implemented (e.g., in the UK the strong focus was on strengthening internal control mechanisms, while in the US was on building up monetary incentives and external audit), (ii) the way these solutions were developed and shaped (e.g., continuous development and revision of the previous recommendations in the UK versus more knee-jerk like responses in the US), and (iii) the way the changes were introduced to the market (voluntarily in the UK and compulsory in the US). In this section I discuss challenges that remain.

##### **4.1. Understanding alternative regulatory approaches**

One of the primary challenges that still remains despite all that has been done to improve corporate governance and all the research into the subject, is to understand what works (e.g., Korczak and Liu, in this issue; Evans and Schwartz, in this issue). This is not to say that common themes and views are not emerging. For example, given that problems of corporate governance predominantly arise because of asymmetries of information between agents and principals and that when possible prevention is better than cure, then efforts towards reducing the asymmetry should be directed towards ex ante rather than ex post monitoring. This lesson seems to have been learnt by policy makers and creating conditions for effective ex ante monitoring has moved to (or towards) the top of the agenda in numerous countries. Whether specific policies that countries follow can and will in all cases effectively increase the power of boards it is a different question, but the direction of travel for most countries is clear. However, even here challenges still remain as there is little understanding of the optimal structure of the board. Research conducted within one country can deliver contradicting results (e.g., Forbes and Milliken, 1999, and Goodstein et al., 1994, claim that big boards are better, while Judge and Zeithaml, 1992, Eisenberg et al., 1998, stress



difficulties arising when boards are big). Moreover, as it will be discussed below (Section 4.2) solutions developed for one country may not be suitable for another country. Therefore, a challenge over the next years will be to develop more understanding of methods of enhancing ex ante monitoring.

There are arguments in support of the idea of inducing active monitoring by institutional investors. Institutional investors are typically more business savvy than dispersed individual investors. Moreover, for many companies equity stakes of each institutional investor will be bigger than cumulative stakes of individual shareholders, meaning that although alone institutional shareholders may not have enough voting rights to make a change, when unified they may be quite powerful. Given that to get to a level of a meaningful voting power may require cooperation among just a handful of institutional investors, it may be easier to create a lobby among institutional investors than among numerous individual investors.

This concentration may positively impact on the quality and frequency of communication among shareholders, and shareholders and the board, and, therefore, it may strengthen ex ante monitoring. All these benefits, however, do not come for free. There are some potential drawbacks. First, an attempt to reduce agency costs stemming from asymmetry of information between management and shareholders by enhancing activism among controlling shareholders may result in the creation of agency problems between controlling and minority shareholders. A potential conflict among shareholder groups may result from differences in investment horizon and/or level of diversification. Mismatch of investment horizons could potentially be resolved if institutional investors were themselves long-term investors. Pension funds and insurance companies are natural candidates to mitigate agency problems. However, for as long as the rewards of investment managers of these financial institutions are based on short-term performance, it is not clear that pension funds and insurance companies can be considered true long-term investors. Moreover, given a wide range of assets in portfolios of these institutional investors, it may be overoptimistic to expect that they will get involved in monitoring in every company they invest in. The costs of such undertakings would be enormous. Here a careful analysis of costs and benefits is required. As it is, the pension industry around the world struggles to earn appropriate rates of return (e.g., Coggin et al., 1993; Antolin, 2008; Hinz et al. 2010, Petraki and Zalewska, 2013). It is unlikely that the increase in fees needed to compensate pension funds for costs of getting involved in corporate governance monitoring, will be lower than additional returns earned on their investments. It seems that forcing pension funds to exercise their voice may

itself be a costly and ineffective strategy. It might be more optimal to create conditions for their 'exit' if they are not satisfied with company's state of affairs. By the end of a day it is as much the duty of a company to attract and maintain investors, as it is for investors to force companies to be worthy of investing in. Finally, forcing pension funds to get involved in corporate governance of domestic companies may enforce home bias which is against prudent rules of diversification. It may be beneficial to look to the conditions that determine the market for corporate control (e.g., Kim and Palia, in this issue).

When it comes to managerial incentives there also is considerable dispute and unanswered questions about its optimal size and structure. The US pioneered the idea of performance-based remuneration, as a method of alignment executives' and shareholders' interests and of full disclosure of executive remuneration. Nowadays, in spite of cross country differences in equity linked compensation, there seems to be a common trend towards increasing public disclosure of executive remuneration and introducing performance-based compensation. It is not entirely clear that these policies are beneficial. Research evidence on the link between remuneration and performance is mixed, while there is consistent evidence that disclosure resulted in a dramatic increase in the levels of remuneration (e.g., Hayes and Schaefer, 2009). Indeed, according to Forbes, since the Internal Revenue Code passed by Congress in 1993, the average CEO pay in the US increased 200% between 1994-2000. The corporate scandals (e.g., Enron) revealed that the law which was intended to align the interests of executives with those of shareholders may have had undesired consequences. It seems that the law created space for an abuse of shareholders' wealth by powerful executives rather than protected the shareholders' interests.

#### 4.2. Determining the importance of geo-diversity of business culture

A key challenge is to understand the extent to which cross country differences dictate very different solutions to the corporate governance problem. There is considerably more research on American corporate governance than that of any other country, yet because of the specific characteristics of American corporate governance, it is not clear whether these findings inform the issues faced by boards operating in other countries. The limited existing research suggests that one should be careful in making generalisations, even within the Anglo-Saxon system. Zalewska (in this issue) documents a negative relationship between remuneration dispersion of executive directors and firm performance using UK data. This

result contrasts with earlier American studies which document a positive relationship. Also Balafas and Florackis' (in this issue) findings, to some extent, contrast with earlier American studies on the relationship between the equity pay and firm performance in the UK. If such fundamental difference exist within the Anglo-Saxon system, one can expect that differences can be stronger still for countries more culturally different from the US than the UK.

Indeed, as our understanding of corporate governance characteristics at the country level increases (e.g., Pindado et al., in this issue), there is growing awareness that papers based on US data do not have the universal character. As such, what characterises American boards, may not characterise non-American boards, and vice versa. This, however, means that an implementation of American policies targeting corporate government problems arising in the US, to non-US governance systems does not guarantee a success. The reverse argument also applies.

While the researchers start recognising cross-country differences, policymakers still prefer applying 'one-size-fits-all' solutions. This lack of acknowledgement of country specific characteristics and needs is clearly visible in the regulatory policies of the EU. In spite of the fact that the EU countries have very different corporate governance systems, different levels of economic, financial and social development, when it comes to dealing with corporate governance policies, the EU authorities try to impose uniform rules. This is a potential recipe for future problems. The current discussion on bankers' bonuses is a warning sign. The proposed restrictions ignore both economic arguments (e.g., Dong, in this issue) and country specific remuneration practices. Murphy (2013) presents a convincing study of the regulation's "unintended consequences", and why it will not resolve the growing level of remuneration, excess risk taking and low performance.

Another example of potentially unsuccessful policy is the recent decision to encourage separation of the CEO and the Chair positions in the US. Having a strong CEO seems to be the 'American way' of running companies, and to support this view there is growing evidence that breaking the duality has a negative impact on performance (e.g., Brickley et al., 1997; Bloom and Van Reenen, 2010; Dey et al., 2011; Byrd et al., 2012). It is true that the US' reforms of corporate governance in empowering boards seem to lag behind reforms adopted by other countries. It is, probably, also true that within the developed world US CEOs enjoy the highest level of power. Yet, breaking the duality of the CEO and the Chair positions may not be the solution. If the separation is not associated with the introduction of other changes that strengthen the position of the board, and, in particular, of

the independent Chair, then indeed the dissolution of the duality may result in more harm than benefit. If authorities desire to develop more powerful boards, than it will require more than taking some duties off the CEO and passing them to one of non-executive directors (especially if he/she used to be one of executives in the company).

#### 4.3 Overcoming the problems of the political economy of corporate governance

It has become common for politicians to get actively involved in debates on what is good and what is bad corporate governance, and directly implement legally enforceable solutions on the business community. But politicians' time horizons are notoriously different from those of other policy makers. Politicians' portraying themselves as defendants of crisis-stricken nations against the greed of capitalism sells well in some arenas and potentially brings short-term support of part of the electorate. However, it seems to escape the public eye that many of corporate governance issues have arisen as direct and indirect effects of past political policies. The direct effects result from governments introducing and/or supporting the introduction of changes in regulation, codes of practice, etc. The indirect effects are often side effects of the reduction of state ownership and provision. Governments have been deregulating financial markets and reducing governments' direct participation and responsibilities in many areas of business and social responsibility in which, historically, they have had a strong and established presence. This reduction has been happening through the deliberate reduction of state ownership and delivery of services (e.g., through privatisation of state owned companies, PPPs, reduction of state responsibility for old age provision).

Direct political intervention often results in the introduction of draconian laws that throw out the baby with the bathwater. The SOX, the EU regulation on bankers' bonuses, and gender diversity of boards appear to be examples of over-zealous policies. While we will have to wait a few years to observe the effects of the EU policies, the effects of the SOX have been broadly discussed in the literature (also see Evans and Schwartz, in this issue). Also the partial reversal of some of the SOX's requirements by the Dodd-Frank Act (2010) suggests that the initial act was potential 'overreaction' of the authorities. The approach of the US policymakers to the executive remuneration issues also illustrates hit-and-miss policies. First, the initial policies of allowing for, and even supporting, generous compensation were introduced, only to be replaced by draconian restrictions of SOX in 2002. Neither of them

has set the right incentives for executives. All this contrasts with the more considered and evolutionary transformation of British corporate governance that was driven from within the broader business community, albeit, with political support.

## References

- Antolin, P., 2008. Pension fund performance. OECD Working Papers on Insurance and Private Pensions.
- Balafas, N., Florackis, C., 2014, CEO compensation and future shareholder returns: Evidence from the London Stock Exchange, *Journal of Empirical Finance* XXX
- Barber, B.M., Odean, T., 2011. The behavior of individual investors. [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1872211](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1872211)
- Bebchuk, L.A., and J. Fried, 2003, Executive compensation as an agency problem, *Journal of Economic Perspectives* 17, 71-92.
- Bebchuk, L.A., and J. Fried, 2004, *Pay without performance*, Cambridge, MA: Harvard University Press.
- Benartzi, S., Thaler, R., 1995. Myopic loss aversion and the equity premium puzzle, *Quarterly Journal of Economics* 110, 75-92.
- Bloom, N., Van Reenen, J., 2007. Measuring and explaining management practices across firms and countries. *Quarterly Journal of Economics* 122, 1351-1408.
- Bolliger, G., Kast, M., 2007. Executive compensation and analyst guidance: The link between CEO pay and expectations management, (eds.) L. Thevenoz and R. Bahar, *Conflict of Interest: Corporate Governance and Financial Markets*, Kluwer Law International, Ch 4, 137-168.
- Brickley, J., Coles, J., Jarrell, G., 1997. Leadership structure: Separating the CEO and Chairman of the board. *Journal of Corporate Finance* 3, 189-220.
- Byrd, J., Fraser, D., Lee, D., Tartaroglu, S., 2012. Are two heads better than one? Evidence from the thrift crisis. *Journal of Banking & Finance* 36, 957-967.
- Cadbury Committee on the Financial Aspects of Corporate Governance. 1992. Report with Code of Best Practice [Cadbury Report], London: Gee Publishing.
- Coggin, T. D., Fabozzi, F. J., Rahman S., 1993. The investment performance of U.S. equity pension fund managers: An empirical investigation. *The Journal of Finance* 48(3), 1039-1055.
- Hampel, R., 1998. Committee on Corporate Governance, Final Report. [Hampel Report], London: Gee Publishing.

- Canyon, M.J., Core J.E., Guay, W.R., 2011. Are US CEOs paid more than UK CEOs? Inference from risk-adjusted pay. *Review of Financial Studies* 24(2), 402-438.
- Canyon, M.J., Murphy, K.J., 2000, The prince and the pauper? CEO pay in the United States and the United Kingdom, *Economic Journal* 110, F640-F671.
- Dempsey, A.L., 2013. *Evolutions in Corporate Governance. Towards an Ethical Framework for Business Conduct*, Greenleaf Publishing Limited.
- Dey, A., Engel, E., Liu, X., 2011. CEO and board chair roles: To split or not to split. *Journal of Corporate Finance* 17, 1595-1618.
- Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010, Public Law 111 – 203.
- Dong, G.N., 2014, Excessive financial services CEO pay and financial crisis: Evidence from calibration estimation. *Journal of Empirical Finance* XX
- Eisenberg, T, Sundgren, S., Wells, M.T. 1998. Larger board size and decreasing firm value in small firms. *Journal of Financial Economics* 48, 35-54.
- Evans, L. Jr., Schwartz, J., 2014. The Effect of concentration and regulation on audit fees: An application of panel data techniques. *Journal of Empirical Finance* XXX
- Forbes, D. P., Miliken, F.J., 1999. Cognition and corporate governance: understanding boards of directors as strategic decision-making groups. *Academy of Management Review* 24, 489-505.
- German Corporate Governance Code, 2010. Government Commission.  
[http://www.unodc.org/documents/treaties/UNCAC/WorkingGroups/workinggroup4/2012-August-27-29/Responses\\_NVs\\_2012/20120504\\_Germany\\_English\\_3.pdf](http://www.unodc.org/documents/treaties/UNCAC/WorkingGroups/workinggroup4/2012-August-27-29/Responses_NVs_2012/20120504_Germany_English_3.pdf)
- Goodstein, J., Gautam, K., Boeker, W., 1994. The effects of board size and diversity on strategic change. *Strategic Management Journal* 15, 241-250.
- Sir Greenbury, R., 1995. *Directors' remuneration: Report of a Study Group [Greenbury Report]*. London: Gee Publishing.
- Grout P., Jewitt, I., Pong, C., Whittington, G., 1994. 'Audit professional judgement': Implications for regulation and the law. *Economic Policy* 9, 307-351.
- Grout, P.A., Zalewska, A., 2012. The effect of option granting on executive stock purchases, 2012, *Economics Letters* 114, 12-15.
- Hayes R. M., Schaefer, S., 2009. CEO pay and the Lake Wobegon effect. *Journal of Financial Economics* 94, 280-290.
- Higgs, D., 2003. *Review of the role and effectiveness of non-executive directors*, Department of Trade and Industry, London.

Hinz, R. P., Heinz R. and Antolin. P., 2010. Evaluating the financial performance of pension funds. Washington, D.C., World Bank Publications.

Institutional Investment in the United Kingdom: A Review. 2001. [Myners Report]. London: HM Treasury, [www.archive.treasury.gov.uk/pdf/2001/myners\\_report.pdf](http://www.archive.treasury.gov.uk/pdf/2001/myners_report.pdf)

Judge, W., Zeithaml, C., 1992. Institutional and strategic choice perspectives on board involvement in the strategic decision process. *Academy of Management Journal* 35, 766-794.

Kale, J., Reis, E., Venkateswaran, A., 2014. Pay inequalities and managerial turnover. *Journal of Empirical Finance* XXXX

Khan, R., Dharwadkar, R. and Brandes, P., 2005. Institutional ownership and CEO compensation: A longitudinal examination, *Journal of Business Research* 58, 1078-1088.

Kim, T-N., and Palia, D., 2014, Private equity alliances in mergers. *Journal of Empirical Finance* XXXX

Korczak, P., and Liu, X., 2014, Managerial shareholding policies and retention of vested equity incentives. *Journal of Empirical Finance* XXXX

Mobley, M.D., 2005. Compensation committee reports post-Sarbanes-Oxley: Unimproved disclosure of executive compensation policies and practices, *Columbia Business Law Review* 1, 111-190.

Murphy, K.J., 2013. Regulating banking bonuses in the European Union: A case study in unintended consequences. *European Financial Management* 19(4), 631-657.

Odean, T., 1998. Are investors reluctant to realize their losses? *Journal of Finance* 53, 1775-1798.

Ofek, E., Yermack, D., 2000. Taking stock: Equity-based compensation and the evolution of managerial ownership. *Journal of Finance* 55 (3), 1367-1384.

Petraki A. and Zalewska, A., 2013. Jumping over a low hurdle: Personal pension fund performance. University of Bristol, CMPO WP 13/305.

Pindado, J., Requejo, I., de la Torre, C., 2014. Family control, expropriation, and investor protection: A panel data analysis of Western European corporations. *Journal of Empirical Finance* XXX

Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act of 2002 (SOX). Public Law 107-204, 116 Stat. 745.

Shapiro C., Stiglitz, J.E., 1984. Equilibrium unemployment as a worker discipline device. *American Economic Review* 74(3), 433-444.

Schmeling, M., 2007. Institutional and individual sentiment: Smart money and noise trader risk? *International Journal of Forecasting* 23(1), 127-145.

Shleifer, A., Vishny, R.W., 1997. A survey of corporate governance. *Journal of Finance* 52(2), 737-783.

Review of The Institutional Shareholders' Committee Statement of The Role and Duties of Directors - A Statement of Best Practice. 1991. London

Review of The Institutional Shareholders' Committee Statement Of Principles On The Responsibilities of Institutional Shareholders And Agents. 2005. London.

The Tyson Report on the Recruitment and Development of Non-Executive Directors, 2003. [Tyson Report]. London Business School.

Zalewska, A., 2014. Gentlemen do not talk about money: The case of British boards, 2014, Journal of Empirical Finance, XXX